For Consideration, Submitted by: Subcommittee on U.S. Competitiveness

Continuation of Federal R&D Tax Credit

In today's increasingly competitive global economy, the United States must continue to lead the world in research and development. A climate that fosters research and development innovation in all areas, including technology, process and advancement of knowledge, will be the key to maintaining a global competitive advantage for U.S. manufacturers and ensuring our national security. The Federal Government's role in science and research is critical, supporting the development of new technologies that improve our standard of living and well-being.

Background

The R&D tax credit expired on 12/31/05. This happens regularly and re-extension is expected. Of particular concern is what the legislative vehicle for renewal of the credits will be, and when renewal will occur. One key question is whether the extension will be made "seamless," i.e., retroactive to 1/1/06.

- The R&D credit was included in both the House and Senate versions of their 2005 tax cut reconciliation; however, the credit was left out during conference and the bill was signed on 5/17/06 by the President.
- Nearly 16,000 companies of all sizes use the R&D credit – more than 4,500 firms with assets of less than $1 million claimed the credit. Over 60% of the R&D tax credits were claimed by manufacturing.
- Partnerships and Limited Liability Companies with passive investors will experience a tax increase if they utilize the R&D credit because of the Alternative Minimum Tax. This is a disincentive to R&D spending and results in less innovation in small to medium sized companies.

Support for R&D Tax Credit

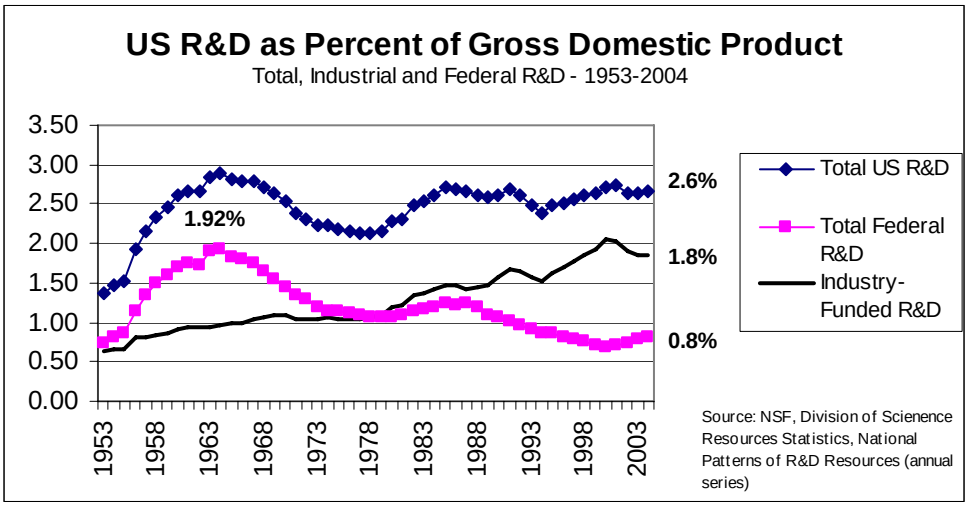
Government support of R&D is vital to sustain and encourage manufacturing in the U.S. Fostering innovation not only enables U.S. manufacturers to remain competitive, but also is a key to improving productivity and enabling start-up companies. Additionally, the R&D credit should be enhanced to include initiatives addressing U.S. energy security issues.

- Investment in R&D is critical to improving productivity. Manufacturing productivity growth averaged 4.9% for 2000-2005 – compared with 3.2% for the non-farm business sector – enabling the economy to grow faster without inflation.
- Manufacturing is one of the primary engines of wealth generation in America, contributing over $1.5 trillion in annual output and accounting for 14% of U.S. GDP. R&D has been the driving force behind U.S. manufacturing competitiveness.
- R&D projects typically have lengthy completion times and require hiring and extensive training of qualified employees. Permanent extension of the R&D credit will add certainty to planning future projects and incentivize R&D spending.

- A 1998 study by Coopers & Lybrand estimated that if the R&D tax credit were made permanent (as opposed to being repealed), companies would spend $41 billion more on R&D over the next 12 years, boosting productivity and adding $13 billion (in 1998 dollars) in economic output per year by 2010.
- Industry uses more than one-third of all energy in the United States. Rising energy costs and energy security concerns have highlighted the need for improved energy efficiency and security. The R&D credit should be enhanced to accelerate these initiatives.
- The President announced the American Competitiveness Initiative (ACI) in January 2006 that focuses on measures to strengthen our nation's ability to compete in the global economy. The President has also called on Congress to make the R&D tax credit permanent and requested through his FY07 budget a Federal R&D investment of more than $136 billion over 10 years.

Potential Repercussions if R&D Credit Is Not Renewed

Private Industry continues to contribute a majority of national spending on R&D and has been supported by the tax credit as an incentive for industry. Expanded support for industry R&D would help maintain manufacturing sector support of energy security initiatives.

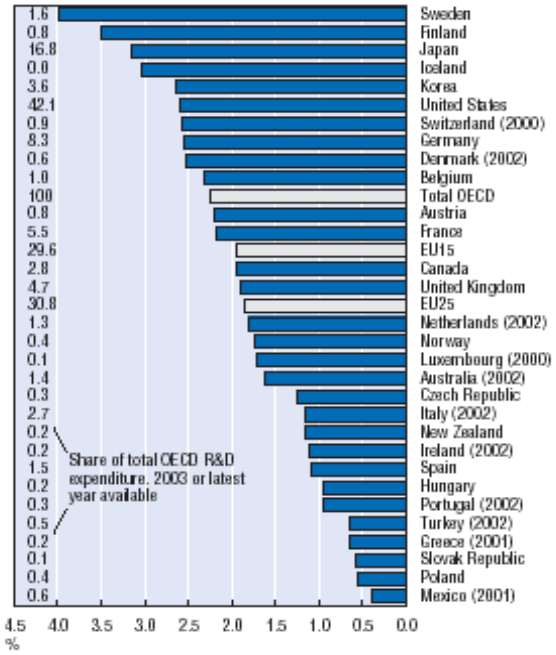


- Private industry has taken on a greater burden and now accounts for two-thirds of the national investment in R&D. For example, in 2004, the federal portion of R&D was 0.80% of GDP, compared with 1.92% in 1964.
- In 2003, manufacturing's employment share was 11%, down from 30.9% in 1950. The U.S. needs to increase its R&D investment to mitigate and offset this decline in manufacturing jobs and protect higher paying jobs.
- The R&D credit primarily targets wages associated with qualified research activities, helping to create jobs in the U.S. In 2001, over $4 billion in R&D tax credit claims were made by the manufacturing industry.

Competitive challenges from the global economy have placed unprecedented pressure on our nation's manufacturing sector. Today, the market drives the location of investment based on growth opportunities. The U.S., as a mature market, has relied on R&D innovation to maintain its competitive stature. Ongoing, the U.S. must strengthen its R&D capability and sustainability in all aspects of manufacturing in order to continue to compete as other markets catch up.

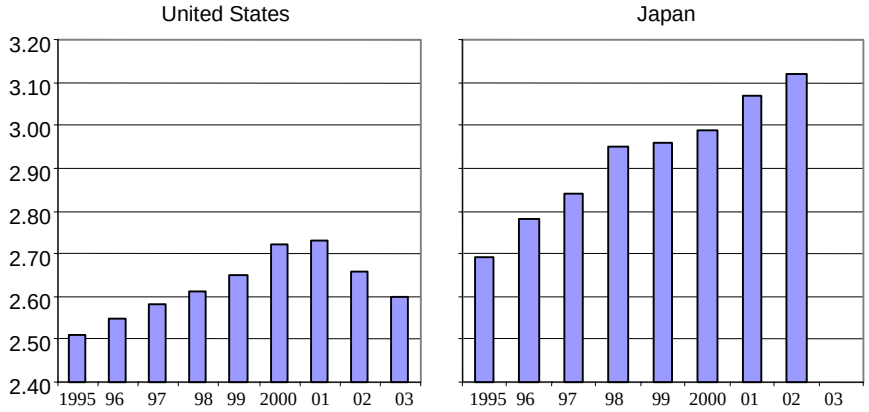
- In 2003, R&D expenditures as a percentage of GDP were over 3% in Sweden, Finland, Japan and Iceland versus 2.6% in the U.S.

National R&D as a Percentage of GDP



- Many U.S. trading partners provide permanent R&D incentives.
  - Canada offers a permanent 20% flat R&D tax credit and many provincial governments offer various R&D incentives.
  - Japan offers a flat 10% R&D tax credit (a 15% flat credit is provided for small companies) in addition to other incentives
  - Korea provides tax holidays, up to 7 years, for high-technology businesses

National R&D as a Percentage of GDP



- Several competitive foreign countries are increasing their R&D investment while the U.S. is decreasing. Since 1995, R&D spending as a percentage of GDP has grown more rapidly in Japan than in the U.S.
- Today, 18 OECD countries have R&D tax incentives in place, compared to only 12 in 1996. The U.S. must strengthen its R&D capability in all aspects of manufacturing in order to remain competitive as other markets catch up.

- In 2003, U.S. majority-owned affiliates invested $22.3 billion in R&D in foreign countries, up from $15.0 billion invested in 1998 – a 49% increase. By comparison, spending on R&D in the United States by U.S. parent companies rose more slowly (by 23%) over this period, from $114.2 billion to $140.1 billion.

Conclusions:

- Investment in R&D is the single most important source of technological advancement leading to higher productivity.
- Private industry contributes a majority of national spending to R&D and has been supported by the tax credit as an incentive to invest in R&D.
- Key competitive foreign countries are increasing their R&D spending more rapidly than the U.S. and many U.S. trading partners provide permanent R&D incentives.
- In order for the U.S. businesses and industry to compete globally, and for our manufacturing economy to avoid sacrificing long-term viability, government must encourage further R&D investment.

Action items:

Support of U.S. R&D investment will encourage global competitiveness. Without this investment, U.S. labor costs become less competitive, restricting our ability to create and maintain high paying jobs. Accordingly, we support the following:

- Approve a seamless extension of the R&D credit for as long as possible with consideration for making it permanent.
- Enhance the level of credit for energy efficiency and energy security supporting the President's initiatives. Develop complimentary R&D tax credits at the state level.
- Include the R&D credit as an allowed deduction under the individual Alternative Minimum Tax calculation.
- Provide enhanced incentives for new and ongoing investment in advanced technologies to improve U.S. based manufacturers' global competitiveness and strengthen our national security.